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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

In re: ENRON CORP., et al.,	M-47 (SAS) **OPINION AND ORDER**
Reorganized Debtors.	**Chapter 11** **No. 01-16034** **Jointly Administered**
ENRON CORP.,	93634
Plaintiff,	**Adversary Proceeding** **No. 05-01025**
-against-	
SPRINGFIELD ASSOCIATES, L.L.C. and WESTPAC BANKING CORPORATION,	
Defendants.	

ENRON CORP.,	:	
Plaintiff,	:	**Adversary Proceeding No. 05-01029**
-against-	:	
AVENUE SPECIAL SITUATIONS FUND II, LP, DK ACQUISITION PARTNERS, LP, RCG CARPATHIA MASTER FUND LTD., RUSHMORE CAPITAL-I, L.L.C. and RUSHMORE CAPITAL-II, L.L.C.,	:	
Defendants.	:	
ENRON CORP., ENRON NORTH AMERICA CORP., NATIONAL ENERGY PRODUCTION CORPORATION, ENRON POWER MARKETING, INC., ENRON POWER & INDUSTRIAL CONSTRUCTION COMPANY, NEPCO SERVICES INTERNATIONAL, INC. and NEPCO POWER PROCUREMENT COMPANY,	:	
Plaintiffs,	:	**Adversary Proceeding No. 05-01074**
-against-	:	
BEAR, STEARNS & CO. INC. and RUSHMORE CAPITAL-I, L.L.C.,	:	
Defendants.	:	

ENRON CORP., ENRON NORTH AMERICA CORP., NATIONAL ENERGY PRODUCTION CORPORATION, ENRON POWER MARKETING, INC., ENRON POWER & INDUSTRIAL CONSTRUCTION COMPANY, NEPCO SERVICES INTERNATIONAL, INC. and NEPCO POWER PROCUREMENT COMPANY,	:	
Plaintiffs,	:	**Adversary Proceeding No. 05-01105**
-against-	:	
BEAR, STEARNS & CO. INC., DK ACQUISITION PARTNERS, LP, MORGAN STANLEY EMERGING MARKETS, INC., RUSHMORE CAPITAL-II, L.L.C., STRATEGIC VALUE MASTER FUND, LTD. and MAN MAC 3 LIMITED,	:	
Defendants.	:	

SHIRA A. SCHEINDLIN, U.S.D.J.:

Certain defendants and permitted intervenors in the above-captioned coordinated adversary proceedings (the "Adversary Proceedings") request leave to file an interlocutory appeal from two orders of the Bankruptcy Court of the Southern District of New York (Gonzalez, J.) denying defendants' motions to

dismiss claims for equitable subordination and for disallowance filed by Enron Corporation and certain of its affiliates (collectively, "Enron").[1] In these opinions the Bankruptcy Court held that a transferee's claim against a bankrupt's estate can be subordinated or disallowed solely because of its predecessor-in-interest's misconduct or failure to return avoidable transfers even when there is no finding of wrongdoing or receipt of avoidable transfers by the transferee.

Defendants and permitted intervenors move for leave to appeal on the grounds that both the subordination and disallowance opinions are erroneous as a matter of law and that immediate appeal is warranted because of the uncertainty that these rulings – if left undisturbed – would inject into the market for the sale of postpetition claims. They argue, in the alternative, that if a claim can be subordinated and disallowed based solely on a transferor's acts or omissions, then

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[1] The published order from which leave to appeal is sought with respect to equitable subordination is *Enron Corp. v. Avenue Special Situations Fund, II, LP* (*In re Enron Corp.*), 333 B.R. 205 (Bankr. S.D.N.Y. 2005) (the "subordination opinion"). The Bankruptcy Court issued substantially similar unpublished opinions in the three other adversary proceedings that have been coordinated for the purposes of this motion, as explained *infra* in Part I of this Opinion. The published order on claim disallowance is *Enron Corp. v. Avenue Special Situations Fund, II, LP* (*In re Enron Corp.*), 340 B.R. 180 (Bankr. S.D.N.Y. 2006) (the "disallowance opinion"). The Bankruptcy Court has not issued similar opinions in the three other adversary proceedings as of today's date, although it has so-ordered a stipulation allowing defendants and permitted intervenors to brief the issue as if similar orders had already been entered in the three other proceedings.

the Bankruptcy Court erred by not allowing a "safe harbor" defense for claims that are acquired in good faith and for value. They argue that these holdings unfairly make transferees strictly liable for their transferors' conduct.

Enron, in turn, argues that the opinions were correctly decided based on both statutory construction and equitable principles, despite the absence of any controlling authority. Enron argues that if a transferor can immunize its claims from being subordinated and disallowed by transferring them to a good faith purchaser, this would encourage claim holders who have acted inequitably or who have failed to repay avoidable transfers to "wash" their claims by transferring them. Enron asserts that such an outcome would defeat the very purposes behind equitable subordination and claim disallowance.

Although the parties have separately briefed the subordination and disallowance opinions, both motions for leave to appeal are addressed here together because they both involve the same question – whether a transferee's claim can be subordinated or disallowed solely because of the acts or omissions of its predecessor-in-interest. For the following reasons, defendants and intervenors' motions for leave to appeal are granted.

I. BACKGROUND

On December 2, 2001 (the "Petition Date"), Enron filed voluntary

petitions for relief under chapter 11 of title 11 of the United States Code (the "Bankruptcy Code").[2] As of the Petition Date, Enron was an obligor under various credit agreements (the "Credit Arrangements") with certain participating banks (collectively, the "Transferors" or "Intervenors") whose proofs of claim were authorized by the Bankruptcy Court.[3] After the Petition Date, the Transferors, who were the original holders of claims asserted against Enron's estate, directly or indirectly transferred the claims to the defendants (or "Transferees") in this case.[4]

On September 24, 2003, Enron filed an adversary proceeding (the "MegaComplaint Proceeding," Docket No. 03-09266) against ten large bank groups, including all of the Transferors that have been allowed by the Bankruptcy Court to intervene in this motion.[5] In that action, Enron alleges that the Transferors received certain preferences and fraudulent conveyances and that they

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[2] *See In re Enron*, 333 B.R. at 211.

[3] *See id.* at 212.

[4] *See id.*

[5] *See id. See also* Debtors' Complaint for the Avoidance and Return of Preferential Payments and Fraudulent Transfers, Equitable Subordination, and Damages, Together with Objections and Counterclaims to Creditor Defendants' Claims. Enron filed amended complaints on December 1, 2003, April 30, 2004, June 14, 2004 and January 10, 2005.

aided and abetted Enron's accounting fraud thereby injuring Enron's creditors. Enron seeks recovery of the allegedly improper transfers to the Transferees and equitable subordination of the banks' claims under the Credit Agreements based on allegations of the Transferors' inequitable conduct. The Bankruptcy Court has not yet adjudicated the allegations in the MegaComplaint Proceeding, which the Transferors "vigorously contest."[6]

Enron commenced adversary proceedings in the Bankruptcy Court on January 10, 2005, seeking to subordinate and disallow the claims against Enron's estate, which were held by the Transferors as of the Petition Date and subsequently transferred to and asserted by the defendants in these Adversary Proceedings.[7] The complaints filed in these Proceedings each assert two causes of

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[6] Intervenor Banks' Memorandum of Law in Support of Defendants' Motions for Leave to Appeal From the Decision of the Bankruptcy Court Regarding Section 510(c) ("Intervenors' Subordination Mem.") at 4; Intervenor Banks' Memorandum of Law in Support of Defendants' Motions for Leave to Appeal From the Decision of the Bankruptcy Court Regarding Section 502(d) of the Bankruptcy Code ("Intervenors' Disallowance Mem.") at 5.

[7] *See, e.g.*, Complaint for the Disallowance and Equitable Subordination of Claims Against the Reorganized Debtor Formerly Held by Citigroup, Inc., or its Affiliates, No. 05-01025, dated January 10, 2005 (the "Citigroup Proceedings"). Enron filed similarly styled complaints (collectively, the "Adversary Complaint") against: claims formerly held by Fleet National Bank or its affiliates on January 12, 2005, No. 05-01029 (the "Fleet Proceeding"); claims formerly held by Credit Suisse First Boston or its affiliates on January 19, 2005, No. 05-01074 (the "CFSB Proceeding"); and claims formerly held by

action, one for the disallowance of claims under section 502(d) of the Bankruptcy Code and the other for equitable subordination of claims under section 510(c).[8]

Enron asserts that if the claims still belonged to the Transferors, they would have been subject to disallowance under section 502(d) and subordination under section 510(c).[9] Enron then argues that the transferred claims should be subordinated and disallowed to the same extent as if the Transferors still held them even though there is no allegation that any of the Transferees did anything improper, nor that they received any avoidable transfers.[10] Therefore, the sole basis for Enron's section 502(d) and section 510(c) allegations is the alleged acts and omissions of defendants' predecessors-in-interest coupled with the argument that the transference of such claims should have no impact on the applicability of disallowance or subordination.

After defendants moved to dismiss these adversary proceedings, the Bankruptcy Court entered an order on April 27, 2005 to coordinate briefing on the following issues: whether a claim asserted by a transferee is subject to

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Barclays Bank or its affiliates on February 2, 2005, No. 05-01105 (the "Barclays Proceeding").

[8] *See* Adversary Complaint ¶¶ 50-61.

[9] *See id.* ¶¶ 52-53, 58.

[10] *See id.* ¶¶ 54, 59.

subordination under section 510(c) or disallowance under section 502(d) solely because the transferor is found to have engaged in conduct that would warrant equitable subordination or disallowance if the claims were still held by the transferor.[11] This order also allowed the Intervenor Banks, who are named defendants in the MegaComplaint Proceeding, to intervene for the purposes of briefing and arguing these issues.[12] The Transferors have been and remain interested in these adversary proceedings because they may ultimately be liable for the claims they transferred. That is, if such claims are found to be subject to subordination and disallowance and therefore lose monetary value, then the Transferees are likely to seek indemnity from their Transferors.[13]

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[11] *See* 4/27/05 Coordinated Scheduling and Intervention Order ¶ 2 ("[W]hether a claim asserted by a transferee that acquired its claim on or after [the Petition Date] directly or indirectly, from a defendant in the MegaComplaint Proceeding (each, a 'MegaDefendant') that is alleged to have held such claim on the Petition Date, is subject to (a) subordination under section 510(c) of the Bankruptcy Code solely because such MegaDefendant transferor is found to have engaged in wrongful or inequitable conduct that would warrant equitable subordination of such claim in the hands of such MegaDefendant transferor, or (b) disallowance under section 502(d) of the Bankruptcy Code to the extent that a MegaDefendant transferor(s) that held the claim on or after the Petition Date is found to be an entity from which property is recoverable, or a transferee of avoidance transfers, under section 502(d) of the Bankruptcy Code.").

[12] *See id.*

[13] At least one of the Transferees has already brought suit against its Transferor, referencing the suit that Enron has brought against it in the Adversary

On November 17, 2005, the Bankruptcy Court denied the motion to dismiss with respect to Enron's equitable subordination claim in the Fleet Proceeding.[14] The Bankruptcy Court made two rulings of first impression in the Second Circuit. *First*, the court held that "a claim in the hands of a transferee, either as an initial transferee or a subsequent transferee, who received that claim from a transferor found to have engaged in inequitable conduct is subject to the same equitable relief, as if, [sic] such claim were still held by the transferor."[15] *Second*, the court held that "the policy underlying the 'good faith' defense in various provisions of the Bankruptcy Code does not warrant the extension of such

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Complaint and seeking damages for breach of warranty based, in part, on an indemnity clause in the contract. *See* 8/4/05 Complaint in *Westpac Banking Corp. v. Citibank, N.A.*, No. 05 Civ 6939 (MBM). This case has been transferred by the Judicial Panel on Multidistrict Litigation to the Southern District of Texas. *See* 2/15/06 Transfer Order.

[14] *See supra* note 1. On November 28, 2005, the Bankruptcy Court issued opinions in the Citigroup, CSFB and Barclays Proceedings that are substantially identical to the November 17 equitable subordination ruling in the Fleet Proceeding. On December 20 and 23, 2005, the Bankruptcy Court entered orders implementing its equitable subordination rulings in the various adversary proceedings. On December 23, 2005, the Bankruptcy Court entered an order coordinating the Fleet, Citigroup, CSFB and Barclays Proceedings for purposes of briefing the motion for leave to appeal the orders denying the motions to dismiss the claims for equitable subordination. That order also permitted the Transferors to brief the issue and they have filed the principal memorandum in support of the motions for leave to appeal the subordination ruling.

[15] *In re Enron*, 333 B.R. at 210.

defense to purchasers of claims."[16] The court also concluded that even if such a good faith defense was available, it could not be invoked by the defendants because as purchasers of post-petition bankruptcy claims, the transferees were on notice of the risk that such claims could be subordinated.[17]

On March 31, 2006, the Bankruptcy Court denied the motions to dismiss with respect to Enron's claim for disallowance in the Fleet Proceeding. The central holding of that ruling is: "Once it is established that a claim in the hands of the transferor would be subject to disallowance, such claim in the hands of a transferee should . . . be disallowed to the same extent that such claim would

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[16] *Id.* at 211.

[17] *See id.* The defendants who have moved for leave to appeal the subordination ruling have either joined in the Intervenors' brief without filing their own brief, or have filed a brief in their own name that is substantially identical to the Intervenors' brief. The parties and motions before the Court on the subordination ruling are: (1) Springfield Associates LLC, one of two defendants in the Citigroup Proceeding, has filed a memorandum substantially identical to that filed by the Intervenor Banks; (2) Bear Stearns & Co., Inc. ("Bear"), one of two defendants in the CSFB Proceeding, has moved for leave to appeal relying solely on the Intervenor Banks' brief; (3) Bear, DK Acquisition Partners ("DK"), Strategic Value Master Fund, Ltd. and Man Mac 3 Limited, four of the six defendants in the Barclays Proceeding, have moved for leave to appeal based on their memorandum of law joining in the Intervenors' arguments; (4) DK, RCG Carpathia Master Fund, Ltd. ("RCG"), Rushmore Capital-I, L.L.C. (Rushmore I) and Rushmore Capital-II, L.L.C. (Rushmore II), four of the five defendants in the Fleet Proceeding, have filed a memorandum for leave to appeal that is substantially identical to the Intervenors' brief.

be subject to disallowance in the hand of a transferor."[18] As in its subordination ruling, the Bankruptcy Court held as a matter of law that Transferees cannot assert a good faith defense against claims for disallowance, but even if they could, the defense would fail because Transferees had notice of the risk that the claims they purchased might be disallowed.[19] On April 28, 2006, the Bankruptcy Court entered an order implementing its disallowance ruling in the Fleet Proceeding.[20]

II. LEGAL STANDARD

A. Interlocutory Orders Under Section 158(a)(3)

Appeals from non-final bankruptcy court orders may be taken

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[18] *In re Enron*, 340 B.R. at 199. This issue has been addressed by only two other district courts which reached opposite conclusions. *See In re Metiom, Inc.*, 301 B.R. 634 (Bankr. S.D.N.Y. 2003) (holding that disallowance under section 502(d) applies to the claim and not the claimant) *and Section 1102(A)(1) Comm. of Unsecured Creditors v. Williams Patterson, Inc. (In re Wood & Locker, Inc.)*, No. MO 88 CA 011, 1988 U.S. Dist. LEXIS 19501 (W.D.Tex. June 20, 1988) (holding that disallowance only applies to a claimant).

[19] *Id.* at 205-08.

[20] Because the disallowance ruling was only entered in the Fleet Proceeding, no defendant from any other proceeding has submitted a brief requesting leave to appeal. In the Fleet Proceeding, DK, RCG, Rushmore I and Rushmore II have submitted a memorandum of law that is substantially identical to the Intervenors' brief. The Transferors once again filed the principal memorandum for leave to appeal the disallowance ruling. Therefore, the Court will only cite to and address the arguments raised in the Intervenors' memoranda on both motions.

pursuant to section 158(a)(3) of title 28 of the United States Code.[21] In deciding whether to grant leave to appeal, reviewing courts apply the standards of section 1292(b) of title 28 of the United States Code, which governs the appealability of interlocutory district court orders.[22] In order to permit an interlocutory appeal pursuant to section 1292(b), the order being appealed must "(1) involve a controlling question of law (2) over which there is substantial ground for difference of opinion," and the movant must also show that "(3) an immediate appeal would materially advance the ultimate termination of the litigation."[23] This standard is strictly applied as interlocutory appeals from bankruptcy courts' decisions are "disfavored" in the Second Circuit.[24]

In addition, leave to appeal is warranted only when the movant demonstrates the existence of "exceptional circumstances"[25] to overcome the

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[21] *See also* 28 U.S.C. § 158(c)(2) ("An appeal under subsections (a) and (b) of this section shall be taken in the same manner as appeals in civil proceedings generally are taken to the courts of appeals from the district courts and in the time provided by Rule 8002 of the Bankruptcy Rules.").

[22] *See In re Adelphia Commc'ns Corp.*, No. 03 Civ. 8848, 2006 WL 1114054, at *3 (S.D.N.Y. Apr. 26, 2006).

[23] 28 U.S.C. § 1292(b).

[24] *In re Enron Corp.*, Nos. M-41, 01-16034, 03-93371, 03-93388, 03-93373, 2006 WL 1222035, at *1 (S.D.N.Y. May 3, 2006).

[25] *Williston v. Eggleston*, 410 F. Supp. 2d 274, 276 (S.D.N.Y. 2006).

"general aversion to piecemeal litigation"[26] and to "justify a departure from the basic policy of postponing appellate review until after the entry of a final judgment."[27] Interlocutory appeal "is limited to 'extraordinary cases where appellate review might avoid protracted and expensive litigation,' . . . and is not intended as a vehicle to provide early review of difficult rulings in hard cases."[28] The decision whether to grant an interlocutory appeal from a bankruptcy court order lies with the district court's discretion.[29]

"In regard to the first prong, the 'question of law' must refer to a 'pure' question of law that the reviewing court could decide quickly and cleanly without having to study the record."[30] The question must also be "controlling" in the sense that reversal of the bankruptcy court's order would terminate the action,

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[26] *In re AroChem Corp.*, 176 F.3d 610, 619 (2d Cir. 1999). *Accord Ted Lapidus, S. A. v. Vann*, 112 F.3d 91, 95 (2d Cir. 1997).

[27] *Flor v. Bot Fin. Corp.* (*In re Flor*), 79 F.3d 281, 284 (2d Cir. 1996) (quotation marks and citations omitted).

[28] *Liebert v. Levine* (*In re Levine*), No. 94-44257, 2004 WL 764709, at *2 (S.D.N.Y. Apr. 9, 2004) (quoting *German v. Federal Home Loan Mortgage Corp.*, 896 F. Supp. 1385, 1398 (S.D.N.Y. 1995)).

[29] *See, e.g., In re Kassover*, 343 F.3d 91, 94 (2d Cir. 2003); *DM Rothman Co., Inc. v. Cohen Marketing Int'l, Inc.*, No. 98 Civ. 7905, 2006 WL 2128064, at *1 (S.D.N.Y. July 27, 2006).

[30] *In re Worldcom*, No. M-47, 2003 WL 21498904, at *10 (S.D.N.Y. June 30, 2003).

or at a minimum that determination of the issue on appeal would materially affect the litigation's outcome.[31]

As to the second prong, the "substantial ground for a difference of opinion" must arise out of a genuine doubt as to whether the Bankruptcy Court applied the correct legal standard.[32] The requirement that such a substantial ground exists may be met when "(1) there is conflicting authority on the issue, or (2) the issue is particularly difficult and of first impression for the Second Circuit."[33] However, it is not sufficient that the relevant case law is "less than clear" or allegedly "not in accord"[34] or that there is a "strong disagreement among the parties."[35] The mere presence of a disputed issue that is a question of first

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[31] *See In re XO Commc'ns, Inc.*, Nos. 02-12947, 03 Civ. 1898, 2004 WL 360437, at *3 (S.D.N.Y. Feb. 26, 2004); *North Fork Bank v. Abelson*, 207 B.R. 382, 389-90 (E.D.N.Y. 1997).

[32] *See In re Worldcom*, 2003 WL 21498904, at *10 (citation omitted).

[33] *In re Lloyd's Am. Trust Funds Litig.*, No. 96 Civ. 1262, 1997 WL 458739, at *5 (S.D.N.Y. Aug. 12, 1997) (citing *Klinghoffer v. S.N.C. Achille Lauro*, 921 F.2d 21, 25 (2d Cir. 1990)).

[34] *North Fork Bank*, 207 B.R. at 390 (holding that disagreement between parties about meaning of the term "business trust" did not rise to a level of a "substantial ground for a difference of opinion," because definition of term was not a matter of first impression in the Circuit).

[35] *Statutory Comm. of Unsecured Creditors v. Motorola, Inc. (In re Irridium Operating LLC)*, Nos. 99-45005, 01-02952, M-47, 2003 WL 21507196, at *1 (S.D.N.Y. June 30, 2003) (stating that to demonstrate that there is a

impression, without more, is insufficient to satisfy this prerequisite.[36] The district court must "analyze the strength of the arguments in opposition to the challenged ruling when deciding whether the issue for appeal is truly one on which there is *substantial* ground for dispute."[37] Finally, in regard to the third prong, "'[a]n immediate appeal is considered to advance the ultimate termination of the litigation if that appeal promises to advance the time for trial or shorten the time required for trial.'"[38] Courts place particular emphasis on the importance of this

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substantial ground for difference of opinion a party "must show that the issue is difficult and of first impression and involves more than just a strong disagreement among the parties") (quotation omitted).

[36] *See In re Flor*, 79 F.3d at 284. The Bankruptcy Court notes in both rulings that there is no controlling precedent. *See In re Enron*, 333 B.R. at 216 ("Enron asserts that its position is based on equitable principles, not on the holding of any particular case cited by it."); *id.* at 224 (stating that in determining whether equitable subordination applies, "no case has limited such consideration in the context of a transferred claim to only the conduct of the current holder"); *In re Enron*, 340 B.R. at 195-96 ("The Court has not found any case law mandating that the creditor who received an avoidable transfer be the same entity that actually asserts such claim against the debtor in the bankruptcy proceeding in order for a debtor to assert a section 502(d) disallowance against such a claim.").

[37] *In re Flor*, 79 F.3d at 284 (quotation omitted). *Accord Marlin v. U.S. Trustee*, 333 B.R. 14, 20 (W.D.N.Y. 2005).

[38] *Transportation Workers Union of Am., Local 100, AFL-CIO v. New York City Transit Auth.*, 358 F. Supp. 2d 347, 350 (S.D.N.Y. 2005) (quoting *In re Oxford Health Plans, Inc.*, 182 F.R.D. 51, 53 (S.D.N.Y. 1998)).

last factor.[39]

B. Motion to Dismiss

Rule 12(b)(6) of the Federal Rules of Civil Procedure is incorporated into bankruptcy procedure by Rule 7012(b) of the Bankruptcy Rules. A motion to dismiss pursuant to Rule 12(b)(6) should be granted only if "'it appears beyond doubt that the plaintiff can prove no set of facts in support of [its] claim which would entitle [it] to relief.'"[40] When deciding a motion to dismiss, courts must accept all factual allegations in the complaint as true, and draw all reasonable inferences in plaintiff's favor.[41] "While the pleading standard is a liberal one, bald assertions and conclusions of law will not suffice."[42] Even though the plaintiff's allegations are taken as true, the claim may still fail as a matter of law if it appears

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[39] *See Koehler v. Bank of Bermuda, Ltd.*, 101 F.3d 863, 865-66 (2d Cir. 1996) ("The use of § 1292(b) is reserved for those cases where an intermediate appeal may avoid protracted litigation."); *Lerner v. Millenco, L.P.*, 23 F. Supp. 2d 345, 347 (S.D.N.Y. 1998) ("The Court of Appeals has emphasized the importance of the third consideration in determining the propriety of an interlocutory appeal.").

[40] *Nechis v. Oxford Health Plans, Inc.*, 421 F.3d 96, 100 (2d Cir. 2005) (quoting *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957)).

[41] *See Kirch v. Liberty Media Corp.*, 449 F.3d 388, 392 (2d Cir. 2006) (citation omitted).

[42] *Law Offices of Curtis V. Trinko, L.L.P., v. Bell Atl. Corp.*, 309 F.3d 71, 74 (2d Cir. 2002) (quotation omitted).

beyond doubt that the plaintiff can prove no set of facts in support of its claim which would entitle it to relief, or if the claim is not legally feasible.[43]

III. DISCUSSION

This is one of the rare cases in which an immediate review of an interlocutory order is warranted. The three prongs of section 1292(b) are met here and exceptional circumstances exist. The Bankruptcy Court's two rulings – that equitable subordination and disallowance travel with the claim and that there is no good faith defense – mean that if the Transferors' claims are found to be subject to equitable subordination and disallowance in the MegaComplaint Proceeding, then these findings will automatically subordinate and/or disallow defendants' claims. Enron correctly argues that the denials of the motions to dismiss may never need to be reviewed if the MegaComplaint defendants are not found liable of misconduct or of having received avoidable transfers or if there are settlements in either the MegaComplaint or Adversary Proceedings that end the actions against the defendants.[44] But it is precisely the risk that these orders will go

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[43] *See Allaire Corp. v. Okumus*, 433 F.3d 248, 250 (2d Cir. 2006).

[44] *See* Enron's Memorandum of Law in Opposition to Defendants' Motions for Leave to Appeal From the Bankruptcy Court's Decisions Concerning Equitable Subordination of Claims ("Enron's Subordination Mem.") at 10-11 (citing *U.S. Trustee v. Bethlehem Steel Corp.* (*In re Bethlehem Steel Corp.*), No. 02 Civ. 2854, 2003 WL 21738964, at *4 (S.D.N.Y. July 28, 2003) ("[d]eciding an

unreviewed that makes this an exceptional case.

With respect to the first prong of section 1292(b), the orders being appealed involve pure questions of law and there is no need to make any factual determinations in order to decide whether the rulings are correct. Assuming that the allegations against the Transferors are true – and there are no allegations of impropriety against the transferee-defendants – the question is whether Enron can prevail, as a matter of law, on its equitable subordination and disallowance claims against the defendants.[45] If the answer is yes, then the next question is whether defendants are permitted to assert the defense of being good faith purchasers. Neither of these issues require any factual determination. Finally, the orders involve a controlling question of law. If the Bankruptcy Court's rulings denying

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issue now, which may never need to be decided, does not help to advance the litigation")); Declaration of Richard K. Milin, plaintiff's counsel, in support of Enron's Memorandum of Law in Opposition to Defendants' Motion for Leave to Appeal From the Bankruptcy Court's Ruling Concerning Temporary Disallowance of Transferred Claims under 11 U.S.C. § 502(d) ("Enron's Disallowance Mem.") at ¶ 2 (referring to settlements in the MegaComplaint proceeding).

[45] *See In re Enron*, 333 B.R. at 215 ("Thus for purposes of the Motion to Dismiss, the Court accepts as true all of the material allegations in the Plaintiff's complaint. Further, for purposes of this motion, the Defendants do not dispute any of the factual allegations regarding the [Transferor]. The focus of the Defendant's [sic] motion is that, even if such allegations were true, the cause of action for equitable subordination fails as a matter of law.").

the dismissal of Enron's two causes of action in the Adversary Proceeding are reversed, this may result in the dismissal of these actions in their entirety.

The second prong requires the Court to analyze the strength of the Intervenors' arguments to determine if there is a "substantial ground for difference of opinion."[46] The Intervenors argue that the Bankruptcy Court erred in its subordination opinion by ignoring well-established "principles of equitable subordination" found in the language of section 510(c) and its legislative history, and instead inappropriately relied on analogies to the law of assignments and the assignment of priority wage claims.[47] The Bankruptcy Court drew these analogies to support its conclusion that a transferee could enjoy no greater rights than the transferor.[48] "On the contrary, case law has affirmed the principle that under a bankruptcy proceeding, '[a]n assignee stands in the shoes of the assignor and subject to all equities against the assignor.'"[49] The Bankruptcy Court also referenced two cases holding that the assignment of a claim for wages cannot change the statutory priority of that claim; rather, the claim for wages has the same

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[46] 28 U.S.C. § 1292(b).

[47] *See* Intervenors' Subordination Mem. at 9-16.

[48] *See In re Enron*, 333 B.R. at 223.

[49] *Id.* (quoting *Goldie v. Cox*, 130 F.2d 695, 720 (8th Cir. 1942) (citing *Fidelity Mut. Life Ins. Co. v. Clark*, 203 U.S. 64, 74 (1906))).

priority when held by the assignee as it would have had were it still held by the wage earner.[50]

The Intervenors further argue that the analogy to the law of assignments is misguided because the Bankruptcy Court assumed the truth of its conclusion.[51] If equitable subordination is required no matter who owns the claim, then the analogy to assignment law logically follows. But if the correct interpretation of section 510(c) is that equitable subordination can only apply to a claimant because of its own wrongdoing, then the law of assignments is simply not relevant.[52]

The Intervenors also argue that the Bankruptcy Court erred in interpreting section 510(c) by selectively focusing on one part of the statute and ignoring the rest.[53] Section 510(c) states: "[A]fter notice and a hearing, the court may . . . under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another claim. . . ."

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[50] *See id.* at 223-24 (citing *Shropshire, Woodliff & Co. v. Bush et al.*, 204 U.S. 186, 189 (1907) and *Wilson v. Brooks Supermarket, Inc.* (*In re Missionary Baptist Found. of Am.*), 667 F.2d 1244, 1247 (5th Cir. 1982)).

[51] *See* Intervenors' Subordination Mem. at 14-16.

[52] *See id.*

[53] *See id.* at 9-10.

The Bankruptcy Court focused on the fact that section 510(c) mentions "claims" instead of "claimants" which the Court interpreted to mean that Congress did not intend to limit the section's application to the claimant at the time that the claim was asserted.[54] By contrast, the Intervenors point to the importance of the phrase "principles of equitable subordination" which they claim that the Bankruptcy Court failed to consider.[55]

The Intervenors provide a substantial and facially persuasive argument that the language of section 510(c) and its legislative history, as well as case law, indicate that the "principles of equitable subordination" do not allow the doctrine to be applied to innocent claim holders.[56] Without deciding the merits of this argument, I note that in its leading opinion on equitable subordination, the Supreme Court stated that it "need not decide today whether a bankruptcy court

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[54] *See id.* at 9-14. *See also In re Enron*, 333 B.R. at 225.

[55] *See* Intervenors' Mem. at 9-10.

[56] Because the Supreme Court has already explained that legislative history is useful in interpreting the meaning of the phrase the "principles of equitable subordination" in the context of section 510(c), the Court need not examine whether other avenues of interpretation have been exhausted before considering the legislative history. *See United States v. Nolan*, 517 U.S. 535, 543 (1996). *See also United States v. Boccagna*, 450 F.3d 107, 114 (2d Cir. 2006) ("Only if we conclude that statutory language is ambiguous 'do we resort . . . to canons of construction and, if the meaning [still] remains ambiguous, to legislative history.'") (quoting *Daniel v. American Bd. of Emergency Med.*, 428 F.3d 408, 423 (2d Cir. 2005)).

must always find creditor misconduct before a claim may be equitably subordinated."[57] But the Court did state that "the circumstances that prompt a court to order equitable subordination must not occur at the level of policy choice at which Congress itself operated in drafting the Code."[58]

The important question raised by the Intervenors is whether the Bankruptcy Court, in holding that equitable subordination may be applied to an innocent claim holder, impermissibly operated at "the level of policy choice" which is reserved for Congress. Intervenors make the same argument with respect to the Bankruptcy Court's holding that an innocent transferee cannot assert a good faith defense to a claim of equitable subordination. Intervenors argue that this holding contradicts the Congressional policy choice, revealed in various sections of the Bankruptcy Code, that protects the claims of innocent transferees.[59]

Enron argues that the Bankruptcy Court's holding that transferring a claim cannot immunize it from subordination is correct "as a matter of precedent, policy, equity and common sense."[60] To reverse this holding would authorize

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[57] *Nolan*, 517 U.S. at 543.

[58] *Id.*

[59] *See* Intervenors' Subordination Mem. at 16-18; *see also* Intervenors' Disallowance Mem. at 17-18.

[60] Enron's Subordination Mem. at 5.

creditors to "wash" their claims through transfer, thereby eliminating the remedy of equitable subordination, which no court decision has ever endorsed.[61] Enron maintains that the Intervenors' argument that an innocent transferee's claims can never be subordinated is erroneous.[62] As noted earlier, the Supreme Court in *Nolan* left open the question of whether there must always be creditor misconduct before a claim may be subordinated. After *Nolan*, two appellate courts have held that in certain circumstances, such as stock redemption claims and prepetition tax penalties, creditor misconduct is not a prerequisite for the application of disallowance.[63]

Enron next argues that purchasers of postpetition claims are well aware of the risk that the claims they purchase may be subordinated, and protect themselves from this risk by obtaining contractual indemnities which are not available to those creditors whose claims arose prepetition. Relying on such indemnities (or other contractual rights), some Transferees in these proceedings

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61 *See id.* at 26-28.

62 *See id.* at 32-35.

63 *See id.* at 33 (citing *SPC Plastics Corp. v. Griffith (In re Structurelite Plastics Corp.)*, 224 B.R. 27, 35 (6th Cir. B.A.P. 1998) and *In re Lifshultz Fast Freight*, 132 F.3d 339, 348 (7th Cir. 1997)).

have sued their Transferors for transferring tainted claims.[64] Enron argues that this explains why the Transferors have taken the lead in litigating this motion: "the Transferors are asking this Court to make an immediate ruling that Enron must pay 'innocent' claim assignees so that the Transferors – despite the inequitable conduct alleged in [MegaComplaint Proceeding] – do not have to. Nothing could be more inequitable."[65] Enron asserts that the subordination ruling correctly held that as a practical matter, it would be unduly burdensome to require bankruptcy estates to make distributions to all innocent claimants and then bring an action against transferors for recompense. Finally, Enron argues that the Congressional policy of protecting innocent transferees is best served by protecting Enron's prepetition creditors who have acted in good faith and by not requiring them to share their recoveries from the estate with creditors, or their transferees, who "acted inequitably to the innocent creditors' detriment."[66]

This summary of the various arguments reveals a substantial ground for a difference of opinion on a difficult issue of first impression in this circuit. Thus, the requirements of the second prong are met with respect to the issues

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64 *See id.* at 36.

65 *Id.* at 27-28.

66 *Id.* at 41.

raised on the appeal of the subordination ruling.

The same is true of the disallowance ruling. The Intervenors argue that the Bankruptcy Court ignored both the plain language of, and the purpose behind, section 502(d), relying instead on its own policy preferences.[67] Section 502(d) states:

> [T]he court shall disallow any claim of any entity from which property is recoverable under section 542, 543, 550, or 553 of this title or that is a transferee of a transfer avoidable under section 522(f), 522(h), 544, 545, 547, 548, 549, or 724(a) of this title, unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable under section 522(I), 542, 543, 550, or 553 of this title.

The Bankruptcy Court interpreted this statute to mean that disallowance applies to a claim without reference to its holder: "This statutory reference is to *any claim*. There is no requirement that a claim subject to a section 502(d) disallowance be related to an avoidable transfer."[68]

The Intervenors argue that the Bankruptcy Court erroneously isolated the words "any claim" from the rest of section 502(d) and that the correct statutory reference is to "any claim of any entity that is a transferee of a transfer avoidable"

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[67] *See* Intervenors' Disallowance Mem. at 1-3.

[68] *In re Enron*, 340 B.R. at 194.

under the Bankruptcy Code.[69] The statutory language does not focus on "any claim" but rather on "*any entity*" that has received an avoidable transfer. Because there are no allegations that the defendants have received any avoidable transfers, their claims cannot be disallowed by the first clause of section 502(d). This reading is further supported by the final clause of section 502(d) ("unless such entity . . . .") which explains that disallowance cannot be applied when the entity has "turned over" any transfer for which it is liable. The Intervenors argue that this last clause again shows that the focus of section 502(d) is on the entity and not the claim, because only the entity that has received the avoidable transfer is capable of turning it over so as to prevent the claims from being disallowed.[70]

The legislative history of section 502(d), as well as the case law, indicate that its purpose is to promote a fair distribution of the estate's assets by disallowing a creditor from asserting a claim until he pays the estate what he owes.[71] The Intervenors argue that this purpose is not implicated here because the Transferors who allegedly received avoidable transfers are not asserting claims

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[69] *See* Intervenors' Disallowance Mem. at 10 (quoting § 510(d)).

[70] *See id.* at 11.

[71] *See id.* at 14-16 (citing, *inter alia*, *Campbell v. United States* (*In re Davis*), 889 F.2d 658, 662-63 (5th Cir. 1989); *Sharp v. Chase Manhattan Bank USA, N.A.* (*In re Commercial Fin. Servs., Inc.*), 322 B.R. 440, 452 (N.D. Okla. 2003)).

against the estate while the Transferees who are asserting claims are not alleged to have improperly received transfers.[72] The Bankruptcy Court found that the coercive purpose of section 502(d) in forcing debts to be repaid could be effectively met by disallowing defendants' claims, thereby forcing them to seek indemnity from the Transferors.[73] The Transferors argue that this indirect attempt at coercion will not be effective when transferees lack indemnity agreements and that it contravenes the Congressional policy choice of protecting good faith purchasers.[74] Finally, the Intervenors claim that the Bankruptcy Court erroneously relied on policy justifications in holding that claims can be disallowed regardless of who holds them.[75]

Enron, by contrast, argues that the Bankruptcy Court correctly applied the disallowance provision of section 502(d) by refusing to allow creditors

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72 *See id.* at 15.

73 *See In re Enron*, 340 B.R. 202-03.

74 *See* Intervenors' Disallowance Mem. at 17.

75 *See In re Enron*, 340 B.R. at 205 ("When one balances the harm to the other members of the injured-creditor class as against the risks to a claim-purchaser who voluntarily becomes a participant in the bankruptcy process, the interests of the other members of the injured-creditor class prevail.").

to immunize their claims by transferring them.[76] Enron argues that bankruptcy law has consistently found that transferees cannot stand in any better position than their assignor.[77] For example, a creditor's rights are generally determined by reference to the petition date, such that postpetition transferors are unable to alter a claim's characteristics.[78] Enron disputes Transferors' assertion that no case before *Metiom* disallowed a transferred claim, noting that while "the Transferors may have found no *published opinion* directly on point, [ ] that may mean only that no one *disputed* that transferred claims could be disallowed."[79] Finally, Enron argues that transferees can protect themselves from the risk that their claims will be disallowed through contractual provisions. But if transferred claims are not subject to disallowance, then bankruptcy estates are unprotected as they cannot prevent disreputable creditors from transferring their claims.[80] For these reasons, the disallowance motion meets the requirements of the second prong of section

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[76] *See* Enron's Disallowance Mem. at 2-3; *see id.* at 15-16. *See also In re Metiom*, 301 B.R. at 643 (holding that allowing an assignment to immunize a claim would be a "pernicious result").

[77] *See* Enron's Disallowance Mem. at 19-20.

[78] *See id.* at 20.

[79] *Id.* at 19.

[80] *See id.* at 20-21.

1292(b) because the issues for appeal raise substantial grounds for dispute.

The third prong is easily met, because granting leave to appeal both the subordination and disallowance opinions may result in the disposition of the Adversary Proceedings in their entirety. In its Adversary Complaint, Enron alleged only two causes of action, one for subordination and one for disallowance. The Bankruptcy Court ruled that both causes of action are viable. If both of these opinions are reversed, Enron's case may be dismissed.

V. CONCLUSION

For the foregoing reasons, the defendants and Intervenors' motions for leave to appeal are granted. The parties are to agree on and submit an expedited briefing schedule no later than September 12, 2006.

SO ORDERED:

Shira A. Scheindlin
U.S.D.J.

Dated: New York, New York
September 5, 2006

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